FILE COPY

Supreme Court, U. S.
FILED
JUL 3 1973
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-59

AMERICAN FAMILY MUTUAL INSURANCE COMPANY,
Petitioner,

vs.

LARRY LUKE, Individually, and as Special Administrator of the Estate of LISA LUKE, deceased, and KATHLEEN LUKE,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

HARRY P. THOMSON, JR.
914 Commerce Bank Bldg.
P. O. Box 13007
Kansas City, Missouri 64199
and
JOHN B. SHULTZ
310 South First Avenue
Sioux Falls, South Dakota 57102
Attorneys for Petitioner

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, 421-3030

INDEX

Opinions Below 2
Jurisdiction 3
Questions Presented 4
Statutory and Constitutional Provisions Involved 5
Statement of the Case 6
Reasons for Granting the Writ 9
Conclusion 18
Appendix A—Opinion of the District Court A1
Appendix B—First opinion of the Court of Appeals A9
Appendix C—Order granting rehearing en banc with accompanying supplemental order A23
Appendix D—Opinion of the Court of Appeals en banc A26
Appendix E—Second Petition for Rehearing with Order denying Second Petition A37
Appendix F—Mandate of the Court of Appeals A48
Appendix G—Judgment entered in accordance with mandate A50

Case Citations

Beck v. *Pennsylvania National Mutual Casualty Insurance Company*, 429 F.2d 813 (5th Cir., 1970) 11, 13
Big Band, Inc. v. *Williams*, 202 N.W. 2d 121 (S. Ct. S. Dak., 1972) 16, 17
Comunale v. *Traders & General Insurance Company*, 328 P. 2d 198 (S. Ct. Cal., 1958) 10, 11, 13, 17
Crabb v. *National Indemnity Company*, 205 N.W. 2d 633 (S. Ct. S. Dak., 1973) 14

Erie Railroad Company v. *Tompkins*, 304 U.S. 64, 82 L.Ed. 1188 (1937) 12, 15, 18

Kunkel v. *United Security Insurance Company of New Jersey*, 168 N.W. 2d 723 (S. Ct. S. Dak., 1969) 12, 14

National Service Fire Insurance Company v. *Williams*, 454 S.W. 2d 362 (Tenn. App., 1970) 13

State Farm Mutual Automobile Insurance Company v. *Skaggs*, 251 F.2d 356 (10th Cir., 1957) 11, 13

Western Casualty & Surety Company v. *Herman*, 405 F.2d 121 (8th Cir., 1968) 12

OTHER AUTHORITIES

Special Bulletin of the Defense Research Institute, June, 1973 9

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. .....

AMERICAN FAMILY MUTUAL INSURANCE COMPANY,
Petitioner,

vs.

LARRY LUKE, Individually, and as Special Administrator of the Estate of LISA LUKE, deceased, and KATHLEEN LUKE,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

To: The Honorable, The Chief Justice and the Associate Justices of the Supreme Court of the United States.

The petitioner, American Family Mutual Insurance Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit and its three opinions on rehearing before that Court en banc filed in these proceedings on April 16, 1973.

The timely filed Second Petition for Rehearing was overruled by the Court of Appeals.

OPINIONS BELOW

The opinion of the United States District Court for the District of South Dakota denying the Respondents' recovery for excess over the insurance policy limits is reported at 325 F. Supp. 1330 (D.C. S. Dak., 1971) and appears in the Appendix to this Petition as Appendix A.

The first opinion of the United States Court of Appeals for the Eighth Circuit reversing the District Court and allowing Respondents recovery for the full amount of the damage judgments in excess of coverage limits appears in the Appendix to this Petition as Appendix B and is unreported.

The Order dated December 8, 1972 granting rehearing before the full Court of Appeals for the Eighth Circuit en banc appears in the Appendix to this Petition, with accompanying supplemental order dated December 27, 1972, as Appendix C.

The majority opinion on rehearing affirming the result of the first opinion and the two dissenting opinions of the Court of Appeals on rehearing appears in the Appendix to this Petition as Appendix D and is as yet unreported.

The Second Petition for Rehearing was denied on May 21, 1973, and with the Order of the Court of Appeals denying further rehearing appear in the Appendix to this Petition as Appendix E.

The Mandate of the Court of Appeals to the United States District Court for the District of South Dakota filed on June 6, 1973, appears in the Appendix to this Petition as Appendix F.

The Judgment entered on June 12, 1973, by the United States District Court for the District of South Dakota in accordance with the Mandate of the Court of Appeals appears in the Appendix to this Petition as Appendix F.

JURISDICTION

The first opinion of the Eighth Circuit Court of Appeals (Appendix B, *infra* p. A9) was filed November 2, 1972, reversing the judgment and opinion of the United States District Court of South Dakota and holding that the petitioner was liable for the full extent of judgments in favor of Respondents regardless of coverage limitations in the policy contract. On December 8, 1972, the Court of Appeals on the petition of the Petitioner ordered that the case be reheard en banc (Appendix C, *infra* p. A23). On April 16, 1973, the Court of Appeals en banc by its majority opinion entered an order modifying its earlier opinion, but affirming its earlier judgment (Appendix D, *infra* p. A26). The Second Petition for Rehearing was filed May 9, 1973, and overruled May 21, 1973.

The Mandate of the Court of Appeals issued to the District Court on June 6, 1973, and the Judgment of the District Court was entered in accordance with the Court of Appeals Mandate on June 12, 1973 (Appendix G, *infra* p. A50). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Should not the conflict created by the majority opinion of the Eighth Circuit Court of Appeals in the instant case, holding that the refusal of an insurer to settle claims against its insured within the contractual policy limits is entirely at the insurer's own risk regardless of the justification, contrary to the previous opinions of the Fifth Circuit Court of Appeals in *Beck* v. *Pennsylvania National Mutual Casualty Insurance Company*, 429 F. 2d 813 (5th Cir., 1970) and the Tenth Circuit Court of Appeals in *State Farm Mutual Automobile Insurance Company* v. *Skaggs*, 251 F. 2d 356 (10th Cir., 1957), be resolved by modifying the Eighth Circuit Court of Appeals opinion to conform to the other circuits?

2. Should the Eighth Circuit Court of Appeals, in contravention of *Erie Railroad Company* v. *Tompkins*, 304 U.S. 64, 82 L. Ed. 1188 (1937), be permitted to modify insurance contracts affecting the insurance coverage of citizens of an entire state by adopting the hindsight test of determining the validity of contractual limitations of insurance coverage when there is a refusal to settle claims after the highest court of that state has specifically rejected that test?

3. Should the Eighth Circuit Court of Appeals be permitted to refuse to follow the rule for allowance of damages for breach of contract established by state statutes of South Dakota (South Dakota Civil Law, 21-2-1 and 21-2-5) as interpreted by the Supreme Court of South Dakota, thereby molding the state law so that it impairs the obligation of contracts in violation of Section 10, Article I of the Constitution of the United States?

STATUTORY AND CONSTITUTIONAL PROVISIONS INVOLVED

ARTICLE I, SECTION 10
CONSTITUTION OF THE UNITED STATES

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws; and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such laws shall be subject to the Revision and Controul of the Congress.

No State shall, without the Consent of Congress, lay any Duty of Tonnage, keep Troops, or Ships of War in time of Peace enter into any Agreement or Compact with another State, or with a foreign Power, or engage in War, unless actually invaded, or in such imminent Danger as will not admit of delay.

SOUTH DAKOTA CIVIL LAW
CHAPTER 21-2
DAMAGES FOR BREACH OF CONTRACT

21-2-1. General measure of damages for breach of contract— Uncertain damages not recovered.— For the breach of an obligation arising from contract, the meas-

ure of damages, except where otherwise expressly provided by this code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which in the ordinary course of things, would be likely to result therefrom. No damages can be recovered for a breach of contract which are not clearly ascertainable in both their nature and their origin.

21-1-5. Damages for breach of obligation not to exceed gain from full performance— Exceptions.— Notwithstanding the provisions of these statutes, no person can recover a greater amount in damages for the breach of an obligation than he could have gained by the full performance thereof on both sides, except in the cases specified in statutes providing exemplary damages or penal damages, and in statutes relating to damages for breach of promise to marry, for seduction, or wrongful injuries to animals.

STATEMENT OF THE CASE

Initially, Federal Jurisdiction was based on diversity of citizenship under 28 U.S.C. 1332. Respondents sustained damages in a collision with an automobile driven by Petitioner's insured, Llewellyn. Respondents then obtained a judgment for such damages in excess of the coverage limits provided by the contractual provisions of the insurance policy between Petitioner and Llewellyn. This policy was issued and the automobile collision occurred in the State of South Dakota. Thereafter, Respondents obtained from Llewellyn an assignment of all of his rights against Petitioner. Respondents claimed that Petitioner was liable to them as assignees of Llewellyn for the full extent of their

damage judgments, including the excess over the coverage limits because Petitioner had declined coverage to Llewellyn and refused to settle Respondents' damage claims within the contractual policy limits.

Respondents then filed suit as assignees of Llewellyn against Petitioner in the United States District Court for South Dakota. The District Court held that Petitioner was not liable to Respondents for any excess over the contractual limits of coverage set out in the policy issued to Llewellyn (Appendix A, *infra* pp. A7-A8). For purposes of appeal to the Eighth Circuit Court of Appeals, Larry Luke, et al., Appellants v. American Family Mutual Insurance Company, Appellee, No. 71-1348 and Larry Luke, et al., Appellees v. American Family Mutual Insurance Company, Appellant, were consolidated. The first opinion of the Eighth Circuit Court of Appeals filed November 2, 1972 reversed the District Court and held Petitioner liable for the entire amount of the damage judgment, including excess over the policy limits, applying the per se liability rule that an insurer declines coverage at its own risk regardless of the ground for such denial (Appendix B, *infra* pp. A21-A22).

On rehearing before the Eighth Circuit Court of Appeals en banc three opinions were filed on April 16, 1973 (Appendix D, *infra* p. A26). The majority opinion on rehearing concurred in by six judges again held the Petitioner insurance company liable for the entire damage judgments including excess over the contractual policy limits. Three of the six judges participating in the majority opinion adopted and reaffirmed the Court of Appeals original opinion (Appendix D, *infra* pp. A26-A28). The remaining three judges concurring in the majority opinion did so refusing to adopt the original opinion and concurring in result only (Appendix D, *infra* pp. A28-A34). A dissenting opinion

was filed by Judge Bright on rehearing and a separate dissenting opinion was filed by Judge Stephenson with Judge Gibson concurring (Appendix D, *infra* p. A34).

Subsequent to the filing of the opinion by the Eighth Circuit Court of Appeals on rehearing Petitioner filed its Second Petition for Rehearing which was denied on May 21, 1973 (Appendix E, *infra* p. A37). The Court of Appeals Mandate issued on June 6, 1973 and the District Court Judgment was entered in accordance with the Mandate on June 12, 1973 (Appendix G, *infra* p. A50).

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

1. The Majority Opinion of the Eighth Circuit Court of Appeals on Rehearing in the Instant Case in Effect Holding That the Refusal of an Insurer to Settle Claims Against Its Insured Within the Contractual Policy Limits Is Entirely at the Insurer's Own Risk Regardless of the Justification of Such Refusal Is Contrary to and Is Not Based upon the Application of Any State Law So That the Opinion of the Eighth Circuit Court of Appeals Is In Conflict with the Previous Opinions of the Fifth Circuit Court of Appeals in Beck v. Pennsylvania National Mutual Casualty Insurance Company, 429 F. 2d 813 (5th Cir., 1970) and the Tenth Circuit Court of Appeals in State Farm Mutual Automobile Insurance Company v. Skaggs, 251 F. 2d 356 (10th Cir., 1957), and This Conflict Should Be Resolved.

Providing insurance to the public is a major industry based and structured upon the provisions of the insurance contract. Insurance performs a useful function and supplies a needed service to the public. Coverage limitations in insurance contracts affect underwriting practices, premiums charged, and the availability of insurance. Voiding coverage limitations unreasonably causes confusion and upsets the entire insurance industry.

Concerted campaigns have arisen and are repeatedly used by the insured as one party to these private contracts to invalidate coverage limitations. The advocacy of these tactics is noted in the Special Bulletin of the Defense Research Institute of June, 1973 where it is stated, page 2:

"PLAN AHEAD FOR EXCESS LIABILITY

(a) Use of Excess Letter: Two purposes served through the use of an excess letter are: (1) to wrest control of the timing of the settlement from the insurer, which may often force the insurance company to settle at an early date; and (2) to increase the amount of available coverage. A well written excess letter helps to establish a foundation for proceeding against the company in the event the settlement offer is turned down and a subsequent trial of the case produces a jury verdict for the plaintiff in excess of the policy limit."

The basic question of whether the agreement of coverage limitations made by the parties to the insurance contract will be voided and the insurer exposed to liability over the coverage limits every time the insurer refuses to settle claims against an insured regardless of justification should not be left in doubt. It was specifically noted by the dissenting opinion of Judge Bright in the Eighth Circuit Court of Appeals on rehearing that this is a question which is important and should be resolved (Appendix D, *infra* p. A28).

The first opinion of the Court of Appeals filed November 2, 1972 applied the per se liability rule that an insurer declines coverage at its own risk regardless of the justification or grounds for denial so that if in the final result the insured is held liable for excess over the policy limits then the insurance carrier is liable to the full extent (Appendix B, *infra* p. A10). This is sometimes referred to as the *Comunale* rule, having been first expressed in *Comunale* v. *Traders and General Insurance Co.*, 328 P. 2d 198 (S. Ct. Cal., 1958). In the majority opinion on rehearing three of the concurring judges re-

fused to follow the original opinion and concurred in result only (Appendix D, *infra* p. A28). The effect of the Court of Appeals majority opinion with three judges adopting the original opinion and three judges concurring in result only is to adopt the rule of per se liability expressed in the *Comunale* case, *supra*.

Thus, the majority opinion on rehearing of the Eighth Circuit Court of Appeals conflicts directly with the opinion of the Fifth Circuit Court of Appeals in *Beck* v. *Pennsylvania National Mutual Casualty Insurance Co.*, 429 F. 2d 813 (5th Cir., 1970) and the decision of the Tenth Circuit Court of Appeals in *State Farm Mutual Automobile Insurance Co.* v. *Skaggs*, 251 F. 2d 356 (10th Cir., 1957). In both of those cases there were parallel facts including a declination of coverage and the same issues were presented. The Fifth and Tenth Circuits adopted in those cases the rule that a good faith but mistaken declination of coverage insulates the insurance carrier from an excess judgment for refusal to accept an offer of settlement within the policy coverage.

This conflict between the Circuits on this question was noted by the dissenting opinion of Judge Bright on rehearing by the Eighth Circuit Court of Appeals (Appendix D, *infra* pp. A31-A32). Judge Bright analyzed the cases as applying three different rules in circumstances analogous to those in the instant case. The first rule was noted as that being applied by the Fifth and Tenth Circuits. The second rule is a per se liability based upon the *Comunale* decision, *supra*. The third rule holds an insurer liable for more than the policy limits only when the insurer after declining coverage in good faith is shown to have failed to exercise good faith in refusing to settle or consider settlement of the claim within the limits of the policy. Further, Judge Bright construed the Eighth Cir-

cuit Court decision in *Western Casualty & Surety Co.* v. *Herman,* 405 F. 2d 121 (8th Cir., 1968) as adopting the third rule whereas the initial opinion of the Eighth Circuit Court of Appeals in the instant case adopted the second rule.

Differences between the Circuits or in the same circuit on this issue could be explained when the Federal Courts are applying state law under the doctrine of *Erie Railroad Company* v. *Tompkins,* 304 U.S. 64, 82 L. Ed. 1188 (1937), but that is no explanation for the conflict when the question has not been decided by an appellate court of the state whose law is being interpreted or when the Court of Appeals refuses to follow the state law which has been determined specifically on the issue. In the instant case the Court of Appeals did refuse to follow the state law as expressed by the Supreme Court of South Dakota in *Kunkel* v. *United Security Insurance Company of New Jersey,* 168 N.W. 2d 723 (S.Ct. S. Dak., 1969). The opinion of the United States District Court holding that the Petitioner was not liable for excess over the contractual coverage limits, noted that the *Kunkel* opinion, *supra,* did apply.

The Eighth Circuit Court of Appeals refused to follow the law of South Dakota as interpreted by the Supreme Court of that state in contravention of the *Erie Railroad Co.* v. *Tompkins, supra,* doctrine and in effect applied the per se liability doctrine classified by Judge Bright as the second rule (Appendix D, *infra* p. A31).

The effect of the majority opinion on rehearing of the Eighth Circuit Court of Appeals in the instant case is to adopt the per se liability rule that an insurer, regardless of justification declines coverage at its own risk; that an insurer cannot consider its own interests equally with

that of the insured; that if an insurer denies coverage, then by hindsight, depending upon the ultimate outcome, it is liable for any amount recovered against the policyholder even though that amount may be in excess of the contractual policy limits; and the circumstances involved in the denial of coverage shall be ignored if there was a refusal to settle, no matter how justifiable the declination of coverage was.

In the *Comunale* or per se liability rule the reasons for the declination of coverage are not among factors considered in determining the good faith of the insurance carrier in refusing to settle so that the insurance carrier is held liable for excess over the coverage limits. This is true even though the insured deliberately misstates the facts of the occurrence which in turn leads to the declination of coverage. This was noted in *National Service Fire Insurance Co.* v. *Williams*, 454 S.W. 2d 362 (Tenn. App., 1970). In the dissenting opinion of Judge Stephenson on rehearing before the Eighth Circuit Court of Appeals Judge Stephenson, noting the *Williams* case, *supra*, states (Appendix D, *infra* p. A36):

> "The above case demonstrates the fundamental unfairness of a 'refusal to defend at your own risk' doctrine."

The effect of the opinions by the Eighth Circuit Court of Appeals is to adopt this inherently unfair rule directly in conflict with the decisions of the Fifth and Tenth Circuits in *Beck* and *Skaggs, supra.* This conflict should be resolved so that parties to private contracts of insurance in the states of the various Circuits may know their rights.

2. The Eighth Circuit Court of Appeals in the Majority Opinion on Rehearing in Contravention of the Doctrine of Erie Railroad Company v. Tompkins, 304 U.S. 64, 82 L. Ed. 1188 (1937) Changed Private Insurance Contracts So As to Affect the Insurance Coverage of Citizens of the State of South Dakota by Adopting the Hindsight Test of Determining the Validity of Contractual Limits of Insurance Coverage After the Supreme Court of South Dakota Had Considered and Specifically Rejected That Same Test As Recognized By the Dissenting Opinion of Judges Stephenson and Gibson.

The result of the majority opinion of the Eighth Circuit Court of Appeals on rehearing combined with its initial opinion is to apply the hindsight result test in determining the validity of the contractual provisions limiting coverage based on the issue of the good faith of the insurer in refusing to settle. This was done in spite of the rejection twice of the same test by the Supreme Court of South Dakota. *Kunkel* v. *United Security Insurance Co. of New Jersey,* 168 N.W. 2d 723, 727; and *Crabb* v. *National Indemnity Co.,* 205 N.W. 2d 633 (S.Ct. S. Dak., 1973). Judges Stephenson and Gibson in their dissenting opinion in the Eighth Circuit Court of Appeals on rehearing stated (Appendix D, *infra* p. A34):

> "We specifically reject the contention that South Dakota would apply the rule of *Comunale,* * * *."

The entire *Kunkel* opinion illustrates the policy of the South Dakota Supreme Court to consider all of the relevant factors in determining whether good faith is exercised. A careful study of the *Kunkel* opinion illustrates that it makes no difference whether it is an original declining of coverage with the resulting refusal to defend or a subsequent refusal to settle.

The effect of the majority opinion of the Eighth Circuit Court of Appeals on rehearing, coupled with the original opinion of that Court in the instant case is to eliminate the consideration of the reasons for declining coverage in determining whether the insurance carrier refused the settlement in good faith so that the contractual coverage limitations are valid. In the instant case the events available for consideration by the insurer at the time of the refusal to settle included the reasons for the refusal of coverage. The refusal to defend and the refusal to settle within the policy limits are interrelated and one cannot be ignored in favor of the other in determining the validity of the contractual provisions.

The opinion of the Eighth Circuit Court of Appeals in the instant case fails to follow the state law by adopting the hindsight test and refusing to allow the insurer to consider all of the elements and circumstances existing at the time of the offer of settlement, all in contravention of the doctrine expressed in *Erie Railroad Co.* v. *Tompkins*, 304 U.S. 74, 82 L. Ed. 1188 (1937).

3. The Majority Opinion of the Eighth Circuit Court of Appeals on Rehearing Did Not Follow the Specific Provisions of the South Dakota Statutes Limiting the Allowance of Damages for Breach of Contract and the Interpretation of Those Statutes by the Supreme Court of South Dakota and by Allowing an Assignee of a Party to the Contract to Recover More for Damages for Breach of Contract Than the Contracting Party Would Have Received by Full Performance of the Contract Molded the State Law So As to Impair the Obligations of Contracts in Violation of Section 10, Article I of the Constitution and This Power Was Not Delegated to Any Branch of the Federal Government by the Constitution.

Respondents as assignees of Petitioner's insured stood in no better position than the insured. The insured's action was for breach of contract. The Respondents' action in the District Court was for breach of contract (Appendix A, *infra* pp. A1-A8). South Dakota statutes S.D.C.L. 21-2-1 and 21-2-5 specifically provide that in an action for breach of contract the plaintiff cannot recover an amount exceeding the amount he would have gained by full performance. This interpretation was affirmed by the Supreme Court of South Dakota in the case of *Big Band, Inc.* v. *Williams*, 202 N.W. 2d 121 (S.Ct. S.D., 1972).

If the Petitioner as the insurance carrier had given full performance to the insurance contract and paid the entire amount of policy coverage the Respondents as claimants could not possibly have gained more than the policy coverage. Under the South Dakota statutes, *supra*, and the *Big Band, Inc.* case, *supra*, this would not entitle Respondents to any excess over the contractual coverage limits. To hold otherwise eliminates any meaning to the contract coverage provisions.

Assuming arguendo that the Petitioner did breach the insurance contract even then under the South Dakota law as interpreted by the highest court of that state, the Respondents could not recover excess over the contractual coverage limits.

The dissenting opinion of Judge Bright in the Eighth Circuit Court of Appeals on rehearing in the instant case notes that the specific statute in South Dakota and its interpretation by the highest court of that state cast grave doubt on the applicability of the sweeping pronouncement of the per se liability *Comunale* rule (Appendix E, *infra* pp. A40-A41).

Both the Legislature, by statutes S.D.C.L. 21-2-1 and 21-2-5 and the Supreme Court of South Dakota, in interpreting those statutes in *Big Band, Inc.* v. *Williams, supra*, followed the mandate contained in Section 10, Article I, Constitution of the United States, that, "no state shall . . . pass any . . . law impairing the obligation of contracts." The result of the now controlling opinion of the Eighth Circuit Court of Appeals is to cause the South Dakota law to be cast in a form that violates the constitutional prohibition. This power was not delegated to the United States Government. The obligation of the insurance contract limiting applicable coverage is impaired or destroyed unreasonably when the Court of Appeals holds that the limiting provisions of the contract are void if coverage is declined regardless of the justification for such declination or refusal of settlement.

This point concerning the enforced violation of a constitutional provision was not raised below. The point that the Eighth Circuit Court of Appeals was requiring the state law to be modified contrary to the state statutes and the last decision of the Supreme Court of South Dakota

was raised. In view of the importance of this issue it should be considered by this Court.

In this independent respect the effect of the majority opinion of the Eighth Circuit Court of Appeals on rehearing coupled with its initial opinion is to negate the South Dakota statutes and to refuse to follow the latest opinion of the Supreme Court of South Dakota interpreting those statutes. Regardless of any other questions, on this ground alone the Eighth Circuit Court of Appeals opinion in the instant case ignores the mandate of this Court expressed in *Erie Railroad Co.* v. *Tompkins, supra.*

CONCLUSION

For the reasons stated above a writ of certiorari should issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered on April 16, 1973.

Respectfully submitted,

HARRY P. THOMSON, JR.
914 Commerce Bank Bldg.
P. O. Box 13007
Kansas City, Missouri 64199

and

JOHN B. SHULTZ
310 South First Avenue
Sioux Falls, South Dakota 57102
Attorneys for Petitioner

APPENDIX

APPENDIX A

Larry LUKE, Individually, Larry Luke, as Special Administrator of the Estate of Lisa Luke, Deceased, and Kathleen Luke, Plaintiffs,

v.

AMERICAN FAMILY MUTUAL INSURANCE COMPANY, Defendant.

Civ. 70-24S.

United States District Court,
D. South Dakota, S. D.

April 29, 1971.

Gerald L. Reade, of Brady, Kabeiseman, Light & Reade, Yankton, S. D., for plaintiffs.

John B. Shultz, of Woods, Fuller, Shultz & Smith, Sioux Falls, S. D., for defendant.

MEMORANDUM DECISION

NICHOL, Chief Judge.

This action is now before this court on cross-motions by the several parties for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure. The plaintiffs as assignees of the alleged insured, Herbert Carl Llewellyn, and under S.D.C.L. Sec. 58-23-1 (1967), seek to recover damages from the defendant in the amount of state court judgments totaling $138,840.12 obtained against Llewellyn plus costs, interest on the judgments and attorneys' fees for this action. The action is based on defend-

ant's insurance policy no. 40-054467 issued by defendant to Llewellyn. The plaintiffs allege that defendant unjustifiably denied coverage under the policy, wrongfully refused to defend, and negligently and in bad faith refused to settle within the policy limits. Federal jurisdiction is based on diversity of citizenship under 28 U.S.C. Sec. 1332 (1964).

POLICY COVERAGE

The material facts relating to the issue of policy coverage on the 1967 Pontiac owned by Llewellyn and which was involved in the accident out of which the state court judgments arose are not in dispute. That plaintiffs have a direct cause of action for damages up to the policy limits pursuant to S.D.C.L. Sec. 58-23-1 (1967) is admitted by defendant in its answer. The question determinative of policy coverage is: Did defendant at the time Llewellyn acquired ownership of the 1967 Pontiac involved in the accident insure, under the liability coverage of the policy, all automobiles owned by the named insured? If the defendant did insure all such automobiles on the date in question, the 1967 Pontiac was covered under the "automatic insurance" provisions of the policy.[1]

At all times material to this action defendant insured under the policy in question a 1966 Pontiac owned by Llewellyn. On October 15, 1966, he purchased a 1959 Oldsmobile from Wilson Motor Company, Sioux City, Iowa, while he was working and living in Sioux City on a tempo-

---

1. The "automatic insurance" provisions of the policy afford thirty days automatic coverage to a private passenger or utility automobile ownership of which is acquired by the named insured during the policy period provided: "(2) the company insures under the Liability Coverage, all private passenger and utility automobiles owned by the named insured on the date of its acquisition."

rary basis. Llewellyn operated the 1959 Oldsmobile until on or about January 15, 1967, without obtaining liability insurance on it.

On or about the 15th of January, 1967, the 1959 Oldsmobile became disabled with engine trouble. Llewellyn contacted Anderson, an employee of Wilson Motor, and together they towed the 1959 Oldsmobile to Wilson Motor's place of business. On the morning of the following day, January 16, 1967, Llewellyn unsuccessfully attempted to purchase a different automobile from Wilson Motor. Later the same day Llewellyn purchased the 1967 Pontiac from Souder's Pontiac in Sioux City, Iowa. On February 4, 1967, Llewellyn while driving the 1967 Pontiac was involved in an accident with an automobile occupied by the plaintiffs and their deceased daughter, Lisa Luke.

After a thorough investigation into the facts of the accident and the facts relating to the ownership of the 1959 Oldsmobile and the 1967 Pontiac, the defendant denied coverage on the 1967 Pontiac on the basis that it did not qualify as an "owned" automobile under the terms of the insurance contract.

The insurance contract in question was entered into in South Dakota. Since no intent on the part of the parties to be bound by the law of some other place has been shown, the policy must be construed in accordance with South Dakota law. American Service Mutual Ins. Co. v. Bottum, 371 F.2d 6, 8-9 (8th Cir. 1967); Briggs v. United Services Life Ins. Co., 80 S.D. 26, 117 N.W.2d 804, 806-807 (1962). Under South Dakota law when an automobile insurance policy is susceptible to two constructions, one favorable and one unfavorable to the insurer, the construction which is against the insurer must be adopted. Royal Indemnity Co. v. Metropolitan Cas. Ins. Co. of New York, 80 S.D. 541, 128 N.W.2d 111 (1964); Sun-

shine Mut. Ins. Co. v. Addy, 73 S.D. 595, 47 N.W.2d 285 (1951).

The 1959 Oldsmobile was purchased, licensed and titled in Iowa. This court agrees with the defendant that under Iowa law Llewellyn owned the 1959 Oldsmobile at the time the 1967 Pontiac was acquired. Llewellyn was the registered owner at the time in question and could have obtained possession of the 1959 Oldsmobile by paying Wilson Motor the balance of the purchase price plus costs of storage and towing. ICA § 321.45 (2); Calhoun v. Farm Bureau Mutual Ins. Co., 255 Iowa 1375, 125 N.W. 2d 121 (1963); Varvaris v. Varvaris, 255 Iowa 800, 124 N.W.2d 163 (1963). It remains to be determined, however, whether the 1959 Oldsmobile was at that time an automobile owned by the named insured within the meaning of the applicable policy provisions.

The South Dakota Supreme Court has not yet ruled on the meaning of "owned automobile" in such a context. This court finds that the South Dakota Supreme Court would hold that the phrase "all private passenger and utility automobiles owned by the named insured" contained in this policy "does not contemplate a vehicle which is in such a position or condition that a reasonable person would not include it in a policy of public liability insurance." Canal Ins. Co. v. Brooks, 201 F.Supp. 124, 128 (W.D.La.1962), aff'd. 309 F.2d 751 (5th Cir., 1962); *see also,* Glens Falls Ins. Co. v. Gray, 386 F.2d 520, 524-525 (5th Cir. 1967); Allstate Ins. Co. v. Stevens, 313 F.Supp. 819 (D.C. Hawaii 1970); Lynam v. Employers' Liability Ass. Corp., 218 F.Supp. 383 (D.C.Del.1963), aff'd. 331 F.2d 757 (3rd Cir. 1963); Merchants Mutual Casualty Co. v. Lambert, 90 N.H. 507, 11 A.2d 361, 127 A.L.R. 483 (1940).

In this case the 1959 Oldsmobile was disabled with engine trouble at the time the 1967 Pontiac was acquired

by Llewellyn. The 1959 Oldsmobile was in the possession of Wilson Motor. Three hundred and fifty dollars were owed by Llewellyn on the purchase price of the 1959 Oldsmobile and he was delinquent in his payments. Llewellyn's intentions as to any further use of the 1959 Oldsmobile are evidenced by the purchase of the 1967 Pontiac for use in the same manner as the 1959 Oldsmobile was used. The extent of the disability of the 1959 Oldsmobile is evidenced by the fact that it was later sold by Wilson Motor to Highway 20 Auto Parts, Sioux City, Iowa, a salvage dealer, for seventy-five dollars.

Based on the above recited facts, this court finds that the 1959 Oldsmobile was not an automobile owned by the named insured within the meaning of the "automatic insurance" provisions of the policy at the time the 1967 Pontiac was acquired. Defendant insured, under the liability coverage, all automobiles owned by Llewellyn at the time the 1967 Pontiac was acquired. Therefore, the 1967 Pontiac was covered under the policy and defendant is liable to the plaintiffs up to the policy limits.

EXCESS LIABILITY

The policy limits in this case are $25,000 per person and $50,000 per accident for bodily injury and death. The claim for property damage is within the $10,000 policy limits. The plaintiffs rely on two theories in support of their claim for damages in excess of the policy limits: (1) that the breach of the duty to defend entitles them to such a recovery and, (2) that the defendant breached its duty to exercise good faith in refusing to accept the settlement offers made by the plaintiffs prior to the entry of the state court judgments.

Generally, the breach by an insurer of its duty to defend does not subject it to liability for an amount of a

judgment or settlement which is in excess of the policy limits. Seward v. State Farm Mutual Automobile Ins. Co., 392 F.2d 723 (5th Cir. 1968); Dairyland Ins. Co. v. Hawkins, 292 F.Supp. 947 (S.D. Iowa 1968); *Anno.*, 49 A.L.R.2d 694, Sec. 11. Several recent cases have held, however, that where the insurer has unjustifiably breached its duty to defend and has in addition rejected a settlement offer within the policy limits, the insurer may be held liable for damages in excess of the policy limits. In one line of cases good faith on the part of the insurer in refusing to defend is held not to constitute a defense in an excess action. Foundation Reserve Ins. Co. v. Kelly, 388 F.2d 528 (10th Cir. 1968); Herman v. Western Casualty and Surety Co., 271 F.Supp. 502 (E.D.Mo.1967), aff'd. 405 F.2d 121 (8th Cir. 1967); Comunale v. Traders and General Ins. Co., 50 Cal.2d 654, 328 P.2d 198, 68 A.L.R.2d 883 (1958).

Another line of cases, while recognizing that an insurer may be held liable above its policy limits when a refusal to defend is accompanied by a refusal to settle within the policy limits, conditions such excess liability on a finding that the insurer was guilty of bad faith in refusing to defend. Beck v. Pennsylvania National Mutual Cas. Ins. Co., 429 F.2d 813 (5th Cir. 1970); State Farm Mutual Ins. Co. v. Skaggs, 251 F.2d 356 (10th Cir. 1957); Fidelity & Casualty Co. of New York v. Gault, 196 F.2d 329 (5th Cir. 1952); Dairyland Ins. Co. v. Hawkins, 292 F.Supp. 947 (S.D.Iowa1968); *see also,* Bolling v. Westchester Fire Ins. Co., 309 F.Supp. 4 (E.D.Tenn.1969).

South Dakota has recognized that an insurance company may conduct itself in such a manner as to be held liable for damages in excess of the policy limits. Kunkel v. United Security Ins. Co. of New Jersey, S.D., 168 N.W.2d 723 (1969). *Kunkel* involved a refusal by an

insurance company to settle within the policy limits after it had assumed control of the defense of the action. In *Kunkel* the court conditioned excess liability in that situation upon a finding that the insurer had exercised bad faith in rejecting the settlement offer. It is the opinion of this court that the South Dakota Supreme Court would also condition liability in a case such as the one at bar upon a finding that the insurer exercised bad faith in reaching its decision not to defend.

What constitutes bad faith is difficult to define. Each case must be determined upon its own facts. While something more than mere negligence is required, the character and extent of the insurer's negligence may be considered. Generally speaking, the interests of the insured must be afforded equal consideration to those of the insurer. Kunkel v. United Security Ins. Co. of New Jersey, S.D., 168 N.W.2d 723 (1969).

In this case this court finds as a matter of law that the defendant was not guilty of bad faith on its denial of coverage and refusal to defend. This finding is based on the following factors: (1) defendant conducted a thorough investigation into the facts relative to the existence of policy coverage; (2) Llewellyn was promptly notified of the decision to deny coverage; (3) the clause upon which coverage turns has not been interpreted by the state supreme court; and (4) the interpretation relied upon by the insurer in reaching its decision to deny coverage under the policy was not unreasonable. Beck v. Pennsylvania National Mutual Ins. Co., 429 F.2d 813 (5th Cir. 1970); State Farm Mutual Ins. Co. v. Skaggs, 251 F.2d 356 (10th Cir. 1957); Fidelity & Casualty Co. of New York v. Gault, 196 F.2d 329 (5th Cir. 1952); Dairyland Ins. Co. v. Hawkins, 292 F. Supp. 947 (S.D.Iowa 1968);

see also, Bolling v. Westchester Fire Ins. Co., 309 F.Supp. 4 (E.D.Tenn.1969). The claim for damages in excess of the policy limits is denied.

ATTORNEYS' FEES

This court finds that defendant's refusal to pay the judgments in question was not unreasonable or vexatious under S.D.C.L. 58-12-3 (1967). Plaintiffs' claim for attorneys' fees is denied.

Counsel shall prepare appropriate orders in accordance with this memorandum decision. Plaintiffs are entitled to judgment under the bodily injury and death provisions of defendant's policy no. 40-054467 in the following amounts: (1) Larry Luke—$11,867.50; (2) Larry Luke as Special Administrator of Lisa Luke—$13,132.50; (3) Kathleen Luke—$25,000.00. In addition plaintiff Larry Luke is entitled to judgment in the amount of $1,654.29 under the defendant's property damage coverage. Interest shall run on these amounts from the date of the state court judgment and costs shall be awarded to the plaintiffs.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1972

No. 71-1348

Larry Luke, individually; Larry Luke, as
Special Administrator of the Estate
of Lisa Luke, etc., et al,
Appellants,

vs.

American Family Mutual Insurance Company,
Appellee.

No. 71-1374

Larry Luke, individually; Larry Luke as
Special Administrator of the Estate
of Lisa Luke, et al,
Appellees,

vs.

American Family Mutual Insurance Company,
Appellant.

Appeals from the United States District Court
for the District of South Dakota

Filed November 2, 1972. Appeals from United States District Court for the District of South Dakota. Affirmed in part; reversed in part.

Gerald L. Reade, John R. Kabeiseman, 200 West Third St., Yankton, S.D., for Appellants, Appellees J. B. Shultz, 310 South First Ave., Sioux Falls, S.D., for Appellee, Appellant.

Before VAN OOSTERHOUT, Senior Circuit Judge, LAY and HEANEY, Circuit Judges.

LAY, Circuit Judge. The plaintiffs, Larry Luke, individually and as the administrator of the estate of Lisa Luke, and Kathleen Luke, are the assignees of the insured, Herbert Carl Llewellyn, and the holders of judgments totaling $138,840.12 plus interest, costs and attorney fees against Llewellyn.

The plaintiffs alleged that American Family wrongfully denied coverage under its policy with Llewellyn. Plaintiffs further charged that the company in bad faith failed to settle within the policy limits of its insured's policy. Both parties moved for summary judgment. The trial court found that coverage existed but refused to allow damages in excess of the policy limits. 325 F.Supp. 1330 (D.S.D. 1971). Cross appeals followed. The insurance carrier contests the finding of coverage, and the plaintiffs appeal from the denial of the damages over the policy limits. We affirm the trial court's finding that coverage should have been afforded the insured, however, we find that the insurer was liable for the full amount of the judgment in excess of its policy limits. We deny plaintiffs their requested attorney fees.

The insured owned a 1966 Pontiac which was covered by American Family's liability policy No. 40-054467. On October 15, 1966, while the 1966 Pontiac was in possession of the insured's estranged wife, Llewellyn purchased for $460 under a conditional sales agreement a 1959 Oldsmo-

bile for his use from Wilson Motor Company of Sioux City, Iowa. An Iowa certificate of title was issued in Llewellyn's name with the car dealer holding it for security. Llewellyn made no effort to insure this car.

On January 15, the Oldsmobile became disabled with engine trouble, and Llewellyn had Wilson Motor tow the car to their garage. Llewellyn still owed $350 on the purchase price. On January 31, 1967, Wilson Motor Co. legally repossessed the Oldsmobile and transferred the title back to its name, however, Llewellyn could have reacquired the title by payment of the contract balance before February 9, 1967. Wilson Motor Co. later sold the car for salvage. On January 16, the day after Llewellyn had Wilson Motor tow in his Oldsmobile, he purchased a 1967 Pontiac from another car dealer in Sioux City. On February 4, 1967, Llewellyn, while intoxicated and driving on the wrong side of the road, was involved in the accident with the Luke family. He was subsequently convicted for manslaughter and sent to prison.

The basic issue as to coverage concerns the "newly acquired automobile" clause under Llewellyn's insurance contract with American Family. The clause reads:

"Owned automobile means . . . b. a private passenger or utility automobile ownership of which is acquired by the named insured during the policy period, *provided* the named insured within 30 days after its acquisition notifies the company thereof and of his election to make the insurance afforded by this and no other policy . . . issued by the company applicable to such automobile *and* . . . (2) the company insures under the Liability Coverage, *all* private passenger and utility automobiles *owned by the named insured on the day of its acquisition* . . ." (emphasis ours.)

American Family denied coverage, arguing that Llewellyn was still the legal title holder to the uninsured Oldsmobile on the date of acquisition of the 1967 Pontiac, therefore, it did not insure *all automobiles* owned by the insured on that date. As a result automatic coverage of the 1967 Pontiac was not afforded.

The district court held that the 1967 Pontiac was covered under the policy since the 1959 Oldsmobile was not an "owned" automobile within the meaning of the "newly acquired automobile" provision at the time the 1967 Pontiac was purchased. We affirm this ruling.

American Family contends that the construction of the newly acquired automobile clause is controlled strictly by the Iowa Certificate of Title statute[1] however, the trial court, citing *Canal Insurance Company v. Brooks*, 201 F. Supp. 124, 128 (W.D.La. 1962) aff'd. 309 F.2d 751 (5 Cir. 1962), held that "the phrase 'all private passenger and utility automobiles owned by the named insured' contained in the policy does not contemplate a vehicle which is in such a position or condition that a reasonable person would not include it in a policy of public liability insurance." 325 F.Supp. at 1332.

Other courts construing the same provision have almost uniformly defined an owned automobile within the policy coverage as an operable automobile, one capable of being used on the streets and highways. See e.g., *Glens Falls Insurance Company v. Gray*, 386 F.2d 520 (5 Cir. 1967), *Patrick v. State Farm Mutual Automobile Insur-*

---

1. Iowa Code Ann. 321.45 reads in part:

"2. No person shall acquire any right, title, claim or interest in or to any vehicle subject to registration under this chapter from the owner thereof except by virtue of a certificate of title issued or assigned to him for such vehicle or by virtue of a manufacturer's or importer's certificate delivered to him for such vehicle. . ."

ance Company, 217 A.2d 909, 912-913 (N.J. 1966), cf. *Lynam v. Employers' Liability Assurance Corp.,* 218 F.Supp. 383, 385 (D.Del. 1963), aff'd 331 F.2d 757 (3 Cir. 1964). The ownership of an automobile which is junk or needs major repairs can hardly be thought to be ownership for liability insurance purposes "since the principal purpose of such insurance is to provide coverage for an automobile which is to be driven and which may become involved in an accident or other mishap." *Glens Falls Insurance Company v. Gray, supra* at 524-525. Cases which have differed from this view have usually done so where the car is temporarily inoperable and is being repaired for future service. *Williams v. Standard Accident Insurance Company,* 322 P.2d 1026 (Cal.App. 1958); cf. *Allstate Insurance Company v. Stevens,* 445 F.2d 845 (9 Cir. 1971).

The 1959 Oldsmobile in the present case was disabled with engine trouble, in fact, Wilson Motor was able to sell it for only $75 to a salvage dealer (the car was "junked out"). After January 15 the Oldsmobile was at all times in the possession of Wilson Motor, and Llewellyn showed no intention of reclaiming it. Moreover, on the day following the vehicle's failure Llewellyn unsuccessfully attempted to purchase a replacement automobile from Wilson Motor, and later that day he bought the 1967 Pontiac from another dealer. Thus, we agree with the trial court that a reasonable construction of American Family's policy would not include the inoperable and abandoned Oldsmobile as an owned automobile.[2]

---

2. It should be noted that "[i]n general the 'newly acquired automobile' clause is intended for the benefit of the insured and should be liberally construed in his favor." *Glacier General Assurance Company v. State Farm Mutual Automobile Insurance Company,* 436 P.2d 533, 535 (Mont. 1968). See also, *Canal Insurance Company v. Brooks,* 201 F.Supp. 124, 128 (W.D.La. 1962), aff'd. 309 F.2d 751 (5 Cir. 1962); 12 Couch on Insurance 2d § 45:185, at 235-236 (1964).

The district court found that American Family exercised good faith in refusing to provide coverage and therefore was not liable for damages over the limits afforded. In *Kunkel v. United Security Insurance Company of New Jersey*, 168 N.W.2d 723, 726 (S.D. 1969), the Supreme Court of South Dakota, in passing on the question of liability of an insurance carrier for excess damages in refusing to settle within policy limits, stated:

"The trial court submitted the matter to the jury under the bad faith rule which we believe to be the better rule and the one prevailing in the majority of jurisdictions and we approve it. . . . However, . . . the character and extent of the insurer's negligence are factors to be considered by the trier of fact in determining if there is bad faith. The insured has the burden of establishing his claim by a preponderance of the evidence."[3]

The federal district court acknowledged two lines of authorities, one holding that good faith *in refusing to defend* is not a valid defense in an excess action where there has been a reasonable offer to settle,[4] and the other line of cases holding a good faith decision in refusing to defend does constitute a defense to an excess action even when accompanied by a refusal to settle within policy limits.[5] The trial court observed that the issue was one of first impression in South Dakota and concluded that

---

3. In adopting this position the South Dakota Supreme Court rejected those decisions which premise liability on evidence of negligence. See generally, 14 Couch on Insurance 2d § 51.5 at 510-511 (1965).

4. See e.g., *Herman v. Western Casualty & Surety Co.*, 271 F.Supp. 502 (E.D.Mo. 1967), aff'd. 405 F.2d 121 (8 Cir. 1968); *Comunale v. Traders & General Insurance Co.*, 328 P.2d 198 (Cal. 1958).

5. See e.g., *State Farm Mutual Automobile Ins. Co. v. Skaggs*, 251 F.2d 356 (10 Cir. 1957); *Dairyland Ins. Co. v. Hawkins*, 292 F.Supp. 947 (S.D. Iowa 1968).

the South Dakota Supreme Court would apply the *Kunkel* good faith test to the present situation. The district court then found that the carrier was in good faith in initially refusing coverage and therefore denied liability for damages in excess of the contract coverage afforded.

Although this court gives special weight to the determination of local law by a federal district judge, a court of appeals cannot be irrevocably bound by a district judge's choice of one or two or more alternative rules to follow in a diversity case.[6] To hold otherwise would be to abdicate our appellate responsibility.

---

6. This circuit has often stated that where the trial judge arrives at a permissible conclusion with respect to the law of his state, such conclusion will be *binding* on appeal. *H. K. Porter Co. v. Wire Rope Corporation of America, Inc.*, 367 F.2d 653, 662-663 (8 Cir. 1966); *Homolla v. Gluck*, 248 F.2d 731, 733-734 (8 Cir. 1957). Only the Sixth Circuit has recited a similar position. See *Lee Shops, Inc. v. Schatten-Cypress Co.*, 350 F.2d 12, 17 (6 Cir. 1965), cert. denied, 382 U.S. 980 (1966); *Rudd-Melikian, Inc. v. Merritt*, 282 F.2d 924, 929 (6 Cir. 1960). The continued application of such a rule has been soundly criticized. See 1 Barron & Holtzoff, Federal Practice and Procedure § 8, at 42-43 (1960); 1A Moore's Federal Practice § .309[2], at 124-125 n. 15 (1971 Supp.); Wright, Law of Federal Courts § 58, at 241 (1970). The legal effect of this principle on questions of first impression is to preclude appellate consideration of an issue involving a significant question of law. The impropriety of the rule is pointed up by Mr. Justice Frankfurter's observation in *Bernhardt v. Polygraphic Company*, 350 U.S. 198, 209 (1956) (concurring opinion): "[T]he defendant is entitled to have the view of the Court of Appeals on Vermont law and cannot, under the Act of Congress, be foreclosed by the District Court's interpretation." See also, *Huddleston v. Dwyer*, 322 U.S. 232, 236 (1944) ("It is the duty of the federal appellate courts, as well as the trial court, to ascertain and apply the state law where . . . [that law] controls [the] decision.") See generally Kurland, Mr. Justice Frankfurter, The Supreme Court and the Erie Doctrine in Diversity Cases, 67 Yale, L.J. 187, 216-218 (1957).

Other circuits have not "bound" themselves to the district judge's initial choice of state law. Rather, they tend to accord "great weight" to the district court's determination of local law unless they believe it to be clearly erroneous. See e.g., *Freeman v. Heiman*, 426 F.2d 1050, 1053 (10 Cir. 1970); *Minnesota Mutual Life Insurance Co. v. Lawson*, 377 F.2d 525, 526 (9 Cir. 1967);

(Continued on following page)

In the instant case American Family was presented with several demands by the plaintiffs and its assured to settle the three cases for $49,000 which was within the limits of the $25,000-50,000 policy. These demands were repeatedly ignored. At one time the plaintiffs offered to hold their suits in abeyance to provide the company an opportunity to file a declaratory judgment suit to determine whether coverage was provided. Although the liability of the company's assured was clear, and the potential damages for the wrongful death of the infant and for the serious injuries to the other plaintiffs were obviously greater than the policy limits, the company refused to consider both settlement and declaratory relief.

The rule announced by the South Dakota court in *Kunkel* is not apposite in determining the precise problem before us. *Kunkel* involved an insurer who assumed its obligation to defend its assured but exercised bad faith in refusing to settle within the policy limits. There exists an important difference between the liability of an insurer who performs his obligation to defend the insured but fails to exercise good faith in settling within the policy limits and an insurer who breaches his contract by failing to defend and who then rejects a reasonable offer to settle.

When it is alleged that the sole breach of duty by the carrier is its refusal to settle within the policy limits, good

---

Footnote continued—

Lomartira v. American Automobile Insurance Co., 371 F.2d 550, 554 (2 Cir. 1967). We feel future adherence to the principles set forth by the Fifth Circuit more adequately reflects a court of appeals' proper course of review: "We give great weight to the view of the state law taken by the district judge experienced in the law of that state, although of course the parties are entitled to review by us of the trial court's determination of state law just as they are of any other legal question in a case." *Freeman v. Continental Gin Co.*, 381 F.2d 459, 466 (5 Cir. 1967). See also *Stool v. J. C. Penney Co.*, 404 F.2d 562, 563 (5 Cir. 1968).

faith becomes the central issue to be decided. On the other hand, good faith is not relevant to an insurer's wrongful breach of its contract to provide coverage. A breach of contract is never justified simply because the offending party in good faith believed he was entitled to refuse performance. When a breach occurs the basic question then concerns the proper measure of damages which flow from the breach.[7] When an insurer refuses to defend and, additionally, refuses to accept a reasonable settlement within the policy limits, the company's liability for damages may be measured as well by its rejection of the offer to settle and may thus exceed the policy limits. As stated by the California Supreme Court in *Comunale v. Traders & General Insurance Co.*, 328 P.2d 198, 202 (Cal. 1958):

> "An insurer who denies coverage does so at its own risk, and, although its position may not have been entirely groundless, if the denial is found to be wrongful it is liable for the full amount which will compensate the insured for all the detriment caused by the insurer's breach of the express and implied obligations of the contract. Certainly an insurer who

---

7. It is generally held that where the only wrongful act of the insurer is the refusal to defend, the liability of the insurer is ordinarily confined to the limits of the policy. *Fidelity & Casualty Co. of New York v. Gault*, 196 F.2d 329 (5 Cir. 1952); *Myers v. Farm Bureau Mutual Insurance Co. of Michigan*, 165 N.W.2d 308 (Mich.App. 1968); *Mannheimer Brothers v. Kansas Casualty & Surety Co.*, 184 N.W. 189 (Minn. 1921). This follows from the general contract principle that upon breach of a contract a party is only entitled to be restored to the same position he was in before the breach. Liability for excess damages does not follow from the failure to defend when there has been no offer to settle within the policy limits. When an assured hires his own counsel it is generally reasoned that damages would not be any less if the insurance company had provided the defense. Furthermore, if the assured is indigent and cannot afford a defense, it can only be assumed a court will allow damages, even upon default, which are prima facie commensurate and reasonable to compensate the injury suffered.

> not only rejected a reasonable offer of settlement but also wrongfully refused to defend should be in no better position than if it had assumed the defense and then declined to settle. The insurer should not be permitted to profit by its own wrong."

See also *Landie v. Century Indemnity Co.*, 390 S.W.2d 558, 564-565 (Mo.App. 1965). Although there exists some authority to the contrary,[8] the vast number of jurisdictions which have considered the question hold that when an offer of settlement within the policy limits has been made and ignored, a good faith refusal to defend is not a valid defense to a claim in excess of the policy limits. *Western Casualty & Surety Company v. Herman*, 405 F.2d 121 (8 Cir. 1968); *Trahan v. Central Mutual Insurance Company*, 219 So.2d 187 (La.App. 1969); *Jenkins v. General Accident Fire & Life Assurance Corp.*, 212 N.E.2d 464, 467 (Mass. 1965); *American Fidelity Fire Insurance Company v. Johnson*, 177 So.2d 679 (Fla.App. 1965), cert. denied, 183 So.2d 835 (1966); *Landie v. Century Indemnity Company*, 390 S.W.2d 558 (Mo.App. 1965); *Comunale v. Traders & General Insurance Company*, 328 P.2d 198 (Cal. 1958). Cf. *Cheek v. Agricultural Insurance Company of Watertown, New York*, 432 F.2d 1267 (5 Cir. 1970); *Foundation Reserve Insurance Company v. Kelly*, 388 F.2d 528, 530-532 (10 Cir. 1968); *Seward v. State Farm Mutual*

---

8. See note 5, supra. The cases holding that good faith in refusing coverage is a proper defense to excess liability fail to offer any reason for the adoption of the rule. The apparent rationale seems to be that since bad faith must be shown on the refusal to settle it necessarily follows that the same rule is applicable when there has been a refusal to defend.

Most legal commentators have rejected the good faith defense to excess liability when applied to the carrier's decision not to defend. Cf. Keeton, Liability Insurance and Responsibility for Settlement, 67 Harv. L. Rev. 1136 (1954). See also 47 Geo. L.J. 601(1959); 57 Mich. L. Rev. 775 (1959); 107 U. Pa. L. Rev. 571 (1959); 10 Hastings L.J. 198 (1958).

Automobile Insurance Company, 392 F.2d 723 (5 Cir. 1968); *Prince v. Universal Underwriters Insurance Company*, 143 N.W.2d 708 (N.D. 1966); *American Home Assurance Company v. Sand*, 253 F.Supp. 942, 949 (D.Ariz. 1965).

There exists another compelling reason for rejecting the company's defense of good faith in denying coverage. By statute South Dakota has adopted a measure of damages for breach of contract which would allow recovery "for all the detriment proximately caused" by the breach. A more simple or explicit expression of the allowable damages can hardly be imagined. S.D.C.L. Ann. §21-2-1 (1967) states:

> "General measure of damages for breach of contract—Uncertain damages not recovered.—For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate the party aggrieved *for all the detriment proximately caused thereby*, or which, in the ordinary course of things, would be likely to result therefrom. No damages can be recovered for a breach of contract which are not clearly ascertainable in both their nature and their origin." (Emphasis ours.)

In *Comunale v. Traders & General Insurance Company, supra* at 202, the California Supreme Court interpreted Section 3300 of the California Civil Code, which is identical to the South Dakota statute[9] (except for the last sentence), to authorize a recovery in excess of the insurer's policy limits upon a breach of the insurance contract. The court declared:

---

9. The annotation to South Dakota Statute 21-2-1, under "source" cites earlier South Dakota Statutes and Section 3300 of the California Civil Code.

> "A breach which prevents the making of an advantageous settlement when there is a great risk of liability in excess of the policy limits will, in the ordinary course of things, result in a judgment against the insured in excess of those limits. Section 3300 of the Civil Code provides that the measure of damages for a breach of contract is the amount which will compensate the party aggrieved for all the detriment proximately caused by the breach, or which, in the ordinary course of things, would be likely to result from its, . . ."
>
> "It is clear that section 3300 of the Civil Code authorizes a recovery in excess of the policy limits. . . ."

Comunale is convincing authority for the proposition that this statutory measure of damages authorizes recovery for the entire judgment even though it exceeds the policy limits.[10]

Comunale concerned an insurer who had wrongfully refused to defend and settle within the policy limits. The assured in *Comunale,* however, was able to employ competent counsel to represent him. In the present case not only did American Family refuse to defend or negotiate a settlement for Llewellyn, but it wrongfully abandoned its assured when he was unable to afford legal counsel and because of his imprisonment, was unable to conduct his own defense. Cf. *Siegel v. William E. Bookhultz & Sons, Inc.,* 419 F.2d 720, 725 (D.C. Cir. 1969).

---

10. The states of Montana and North Dakota have similar statutes and their supreme courts follow the same rationale as *Comunale, Lewis v. Mid-Century Insurance Co.,* 449 P.2d 679, 682-683 (Mont. 1968); *Prince v. Universal Underwriters Insurance Co.,* 143 N.W.2d 708, 715-717 (N.D. 1966).

We find the entire judgment was the natural consequence and proximate result of the defendant's breach of its obligation to defend its assured.

Plaintiffs have also appealed under South Dakota law the denial of attorney fees against the insurer. S.D.C.L. Ann. §58-12-3 (1967) reads:

"In all actions hereafter commenced against any insurance company, including any reciprocal or inter-insurance exchange on any policy or certificate of any type or kind of insurance, if it appears from the evidence that such company or exchange has refused to pay the full amount of such loss, and that such refusal is vexatious or without reasonable cause, the court, if judgment is rendered for plaintiff, shall allow the plaintiff a reasonable sum as an attorney's fee to be recovered and collected as a part of the costs, provided, however, that when a tender is made by such insurance company or exchange before the commencement of the action in which judgment is rendered and the amount recovered is not in excess of such tender, no such costs shall be allowed."[11]

Plaintiffs bring this action under an assignment from the assured and as such possess his rights and claims. The issue of whether there has been a vexatious refusal or a refusal made without reasonable cause is one of fact depending upon the existing circumstances. *Wilson v. Allstate Insurance Co.*, 186 N.W.2d 879, 883 (S.D. 1971), *Tracy v. T. & B. Construction Co.*, 182 N.W2d 320, 323 (S.D. 1970). The trial court held that plaintiffs were not entitled to attorney fees since there was reasonable cause for American Family's refusal of coverage. Plaintiffs have failed to allege any dispute of fact which ordinarily

11. This statute was amended in 1972 to provide attorney fees on appeal as well.

might be left for the jury to resolve.[12] As the trial judge pointed out in discussing the refusal to provide coverage.

> "(1) [D]efendant conducted a thorough investigation into the facts relative to the existence of policy coverage; (2) Llewellyn was promptly notified of the decision to deny coverage; (3) the clause upon which coverage turns has not been interpreted by the state supreme court; and (4) the interpretation relied upon by the insurer in reaching its decision to deny coverage under the policy was not unreasonable." 325 F.Supp at 1334.

We find in the trial court's discussion sufficient basis on which the denial of attorney fees can be affirmed. Even though good faith is not a valid defense for breach of the contract, good faith is essentially relevant to the issue as to whether the refusal was "vexatious or without reasonable cause."

Judgment affirmed in part and reversed in part. The claim is remanded to the trial court for entry of judgment in accordance with our opinion.

---

12. It is likewise doubtful whether the issue of vexatious or unreasonable refusal to provide coverage is one for a jury to resolve. By statute the attorney fees are to be determined and awarded by the court.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1972

No. 71-1348

Larry Luke, individually; Larry Luke, as Special Administrator of the Estate of Lisa Luke, etc., et al,
Appellants,
vs.
American Family Mutual Insurance Company,
Appellee.

No. 71-1374

Larry Luke, individually; Larry Luke as Special Administrator of the Estate of Lisa Luke, et al,
Appellees,
vs.
American Family Mutual Insurance Company,
Appellant.

Appeals from the United States District Court
for the District of South Dakota

The Court has considered a petition for rehearing en banc filed in these cases and it is now here ordered that the petition for rehearing en banc be, and it is hereby, granted. The Clerk of this Court is directed to set these appeals for oral argument and submission to the Court en banc at a session to be later determined.

December 8, 1972

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1972

No. 71-1348

Larry Luke, etc., et al,
Appellants,

vs.

American Family Mutual Insurance Company,
Appellee.

No. 71-1374

Larry Luke, etc., et al,
Appellees,

vs.

American Family Mutual Insurance Company,
Appellant.

Appeals from the United States District Court
for the District of South Dakota

On the Court's own motion it is now here ordered:

1) The Clerk of this Court is directed to set these appeals for oral argument and submission to the Court en banc at the session to be held on Monday, March 12, 1973 in St. Louis, Missouri.

2) The Court directs counsel for the parties to these appeals to file supplemental briefs devoted to the following questions:

a) Under South Dakota law what effect should be given to the insurer's good faith in breaching its contract and declining coverage in determining whether the insurer exercised good faith or bad faith in refusing a subsequent settlement offer within the policy limits?

b) When an insurer breaches its contract and declines coverage what relevancy is SDCL § 21-2-1 in determining an insurer's liability for damages in excess of its policy limits?

c) In view of the considerations given to questions 1 and 2, do any issues in the present case remain to be remanded to the district court?

3) The supplemental briefs called for by this order are to be filed simultaneously by counsel for the parties on or before January 22, 1973. Counsel may then have to and including January 29, 1973 in which to file simultaneous reply briefs.

4) The briefs called for in this order may be in typewritten form. Twelve copies of such briefs should be filed with the Clerk of this Court and additional copies served on opposing counsel. Typewritten briefs are to be on letter-size paper and fastened in the left margin.

December 27, 1972

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 71-1348

Larry Luke, Individually; Larry Luke, as Special Administrator of the Estate of Lisa Luke, Deceased; and Kathleen Luke,
Appellants,
v.
American Family Mutual Insurance Company,
Appellee.

No. 71-1374

American Family Mutual Insurance Company,
Appellant,
v.
Larry Luke, Individually; Larry Luke, as Special Administrator of the Estate of Lisa Luke, Deceased; and Kathleen Luke,
Appellees.

Submitted: March 12, 1973.
Filed: April 16, 1973

ON REHEARING EN BANC

Before Matthes, Chief Judge, Van Oosterhout, Senior Circuit Judge, Mehaffy, Gibson, Lay, Heaney, Bright, Ross and Stephenson, Circuit Judges, *en banc*.

On motion for rehearing it is urged that the South Dakota statute, S. D. Code Ann. § 21-2-1 (1967), governing

damages for breach of contract is not applicable in measuring damages arising from the insurer's failure to settle within the policy limits. However, assuming arguendo that this is true, under the facts of this particular case, we would reach the same result in holding that the insurer is liable for the damages over and above its policy limits.

Assuming the statute is not applicable, the insurer's liability must be measured by the "bad faith" standard set forth in *Kunkel* v. *United Security Insurance Company of New Jersey,* 168 N.W.2d 723 (S.D. 1969). Under the *Kunkel* test the insurer who breaches his contract by refusing to defend would be placed in the same shoes as the insurer who assumes coverage but refuses to settle by accepting an offer to settle within the policy limits.

Applying the *Kunkel* rule of bad faith, it remains undisputed on the present record that the insurer failed to fulfill its responsibility to its insured. The record shows that once the insurer refused coverage it failed to investigate further or even consider the likelihood of excess damage to its insured in light of the facts and circumstances of the case. Under the facts existing here we hold the insurer was guilty of bad faith in refusing to settle as a matter of law.

The defendant urges, however, that a finder of fact should be able to consider the "good faith" of the insurer in denying coverage as one of the factors in considering its good faith in refusal to settle. We reject this argument for the reasons set forth by Judge Van Oosterhout in *Western Casualty & Surety Company* v. *Herman,* 405 F.2d 121 (8 Cir. 1968), adopting the language of *Landie* v. *Century Indemnity Company,* 390 S.W.2d 558 (Mo.App. 1965), that notwithstanding an honest belief by the insurer that the policy is not in effect, the company must in

good faith consider offers for settlement within the limits of the insurance policy. The effect of this holding is that an insurer who breaches its contract to provide coverage is placed in *no better* and in no worse position than if it had assumed coverage when considering whether it acted in good faith in refusing to settle.

We, therefore, reaffirm our prior holding. Judges Van Oosterhout, Lay and Heaney adopt our prior opinion; Judges Matthes, Mehaffy and Ross concur only on the basis set forth in this opinion filed on rehearing.

Bright, Circuit Judge, separately concurring and dissenting, in which Gibson and Stephenson, Circuit Judges, join.

I join in the concurring and dissenting opinion of Judge Stephenson but add my additional views in this case. I feel this case is important, relating, as it does, to the imposition of liability upon an insurer to pay to claimants an amount in excess of policy limits.

The obligation of the insurer toward its insured needs to be evaluated realistically, not by way of hindsight. In this case, application of the literal language of the policy might not impose any liability on the insurer. The language of the policy extended coverage to a newly acquired automobile if the company insures "all * * * automobiles owned by the insured on the date of its acquisition." While the insured purchased a "newly acquired" 1967 Pontiac automobile, he retained ownership of a disabled Oldsmobile which was never brought under the liability policy coverage as well as a 1966 Pontiac which was specifically described in the policy. However, the district court determined that American Family's liability policy extended to the third (Pontiac) automobile because the second (Oldsmobile) automobile, when delivered to

the seller's garage, proved to be unrepairable and thus no longer needed to be considered as a car owned by the insured. Thus the "newly acquired automobile" clause applied to the 1967 Pontiac acquired by the named insured only because the trial court created an exception to the literal language of the policy. Although this construction may be a permissible one, nothing in this record indicates that the insurance carrier should have reasonably anticipated that ruling.[1]

Given the paucity of authority on the subject, we believe the insurer was entitled to view its policy defense as meritorious and justified, subject only to the usual vagaries and uncertainties of litigation.

The panel hearing this appeal initially, on the basis of the *Comunale*[2] case, ruled that the insurer's good faith could not limit its liability for all damages flowing from a breach of contract. Thus, under this contract theory, the insurer who mistakenly relies on a policy coverage defense and fails to consider a settlement within the policy limits becomes strictly liable to the insured for a judgment in excess of the policy limits.

As I understand the opinion on rehearing, three judges not on the original panel and the three concurring and dissenting judges reject the application of the *Comunale* rule to this case. Although the strict liability rule in

---

1. For instance the case of *Canal Insurance Co.* v. *Brooks*, 201 F. Supp. 124, 127 (W.D. La. 1962), *aff'd*, 309 F.2d 751 (5th Cir. 1962), relied upon by the district court for its decision on coverage, is not directly in point. In the *Canal Insurance Co.* case, the omission of the insured, pointed to by the insurer, was the failure to list a certain boat trailer and other unserviceable semitrailers as vehicles which the insured owned. The policy called for a listing of all owned automobiles. No South Dakota court had considered a similar problem of coverage.

2. *Comunale* v. *Traders & General Ins. Co.*, 328 P.2d 198 (Cal. 1958).

Comunale has been frequently cited, this rule has been infrequently applied.[3]

Moreover, the *Comunale* decision was based upon a particular interpretation of California contract law, which is distinguishable from the construction given by the South Dakota Supreme Court to sections of the South Dakota Code which deal with the measure of damages flowing from breach of contract.[4]

Recently, the South Dakota Supreme Court, in *Big Band, Inc.* v. *Williams*, 202 N.W.2d 121 (1972), said of these sections:

> When the action is for breach of contract plaintiff is entitled to recover all his detriment proximately

---

3. The panel decision has cited *Western Casualty & Surety Co.* v. *Herman*, 405 F.2d 121 (8th Cir. 1968), and *Landie* v. *Century Indemnity Co.*, 390 S.W.2d 558 (Mo. App. 1965), as cases supporting the application of the *Comunale* rule. In *Herman*, our affirmance rested upon a specific *finding of fact* by the district court, *Herman* v. *Western Casualty & Surety Co.*, 271 F. Supp. 502 (E.D. Mo. 1967), that the insurer was guilty of bad faith in refusing to settle, notwithstanding that it had sought to litigate a good faith policy defense. In *Landie*, the case authority which underlay our *Herman* decision, the Missouri court, in affirming an excess judgment over the policy limits, made this pertinent observation,

> From this fact situation the jury could well have found, as they did, that the [insurance] company acted in bad faith in refusing to settle. [*Landie, supra*, 390 S.W.2d at 566.]

4. The pertinent sections read:

> For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom. No damages can be recovered for a breach of contract which are not clearly ascertainable in both their nature and their origin. [S.D.C.L. § 21-2-1 (1967).]

> Notwithstanding the provisions of these statutes, no person can recover a greater amount in damages for the breach of an obligation than he could have gained by the full performance thereof on both sides [with exceptions not here applicable]. [S.D.C.L. § 21-1-5 (1967).]

> caused by the breach, *not exceeding the amount he would have gained by full performance.* (Emphasis supplied) [*Id.* at 123.]

The limiting phrase emphasized in the above quotation casts grave doubt upon the applicability in South Dakota of the sweeping pronouncement of *Comunale.*

The strict liability doctrine of *Comunale* represents a minority view which I do not believe would be followed in South Dakota and which the trial court properly rejected.

Courts seem to have applied three different rules in circumstances analogous to those in the instant case, as follows:

1) A rule that a good faith but mistaken declination of coverage insulates the insurance carrier from an excess judgment for refusal to accept an offer of settlement within the policy coverage. This is the rule which Judge Nichol applied in the trial of this case and which was also applied by the Fifth Circuit in *Beck* v. *Pennsylvania National Mutual Cas. Ins. Co.,* 429 F.2d 813 (1970) (Pennsylvania law), the Tenth Circuit in *State Farm Mutual Ins. Co.* v. *Skaggs,* 251 F.2d 356 (1957) (Oklahoma law), and *National Service Fire Ins. Co.* v. *Williams,* 454 S.W.2d 362 (Tenn. App. 1969).

2) The *Comunale* rule, *Comunale, supra,* 328 P.2d 198, of per se liability based on the California statutory law, which rule is not applied in this case by a majority of the court.

3) A middle view which holds an insurer liable for more than the policy limits when the insurer, after declining coverage in good faith, is shown to have failed to exercise good faith in refusing to settle or consider

settlement of the claim within the limits of the policy. I construe the following cases to reflect this view: *Western Casualty & Surety Co.* v. *Herman*, 405 F.2d 121 (8th Cir. 1968); *Foundation Reserve Ins. Co.* v. *Kelley*, 388 F.2d 528 (10th Cir. 1968) (undisputed facts demonstrate bad faith refusal to settle as a matter of law); *Gordon* v. *Nationwide Mutual Ins. Co.*, 30 N.Y.2d 427, 334 N.Y.S.2d 601 (1972); *Landie* v. *Century Indemnity Co.*, 390 S.W.2d 558 (Mo. App. 1965).

The initial panel opinion adopted the second rule. Although the majority of judges sitting *en banc* adopt the third rule, three judges of this *en banc* court join in the reversal of the district court for an alternate reason. These judges hold that, in considering whether a refusal to settle is in good or bad faith, the trier of fact should not give weight to a policy defense held in good faith by the insurer. I believe this view to be erroneous.

The rule applied does not reflect South Dakota law. I note with interest that the majority of this court has adopted this rule as the law of South Dakota without giving the trial judge an opportunity to state his views of South Dakota law.[5] The alternate theory rests solely on the language of two cases arising under Missouri law; *Western Casualty, supra*, and *Landie, supra*. The opinion on rehearing cites no South Dakota case. Yet in *Kunkel* v. *United Security Ins. Co. of New Jersey*, 168 N.W.2d 723 (S.D. 1969), in applying a "bad faith" standard in

---

5. In fact, the majority has completely disregarded the obligation to give "special weight" to the determination of local law by a district judge. Panel slip opinion at 7. Although the district court, on determining good faith, initially gave conclusive weight to the insurer's assertion that it did not believe the insured to be covered under the policy, the majority has declined to allow the trial judge to determine whether, under South Dakota law, a refusal to grant policy coverage made in good faith is even a factor in assessing whether a rejection of a settlement offer was made in good faith.

establishing an insurer's liability to pay more than policy limits for refusing to settle, but where no coverage issue existed, the South Dakota Supreme Court indicated that "any * * * factors tending to establish or negate bad faith on the part of the insurer" should be considered. The *Kunkel* court said:

> Good faith is a broad and comprehensive term. Whether an insurer had adhered to it usually depends upon circumstances and elements involved in a particular case. The decision not to settle must be thoroughly honest, intelligent, and impersonal. It must be a realistic decision tested by the expertise which an insurer necessarily assumes under the terms of its policy. * * *
>
> * * *While no single satisfactory test has been formulated as to what constitutes good or bad faith courts uniformly hold that the insured's interests must be considered. It appears to have been most frequently held the insured's interests must be given "equal consideration" with those of the insurer * * * [168 N.W.2d at 726.]

In light of this language of the Supreme Court of South Dakota, the majority has ignored the local law in this diversity case contrary to the mandate of *Erie Railroad Co.* v. *Tompkins*, 304 U.S. 64 (1938).

In summary, the majority of judges on this *en banc* court have disapproved of the application of the per se rule of the *Comunale* case, discussed above. I join in this disapproval.

The majority of the court, however, have ruled that the insurer's good faith policy defense should not be considered as a factor in determining whether the insurer's refusal to settle a case was in bad faith. I join Judges

Gibson and Stephenson in rejecting this theory. Bad faith, or its converse good faith, is discernible only by taking into account *all* the circumstances of a particular case. The strength of a policy defense plays an important role in the evaluation of a settlement offer. Logically, this factor should be assessed in determining the existence of good faith of the insurer in refusing a settlement offer. In this case, that offer was for almost the full amount of the policy limits. I do not believe the views of the majority can be justified on the basis of sound judicial policy applicable to cases of this kind nor as consistent with South Dakota law as reflected in *Kunkel, supra.*

Accordingly, I would remand this case to the district court for its further consideration.

Stephenson, with whom Gibson and Bright join, concurring and dissenting.

We concur with the majority in affirming the trial court's finding of coverage. We dissent on the excess liability issue.

We specifically reject the contention that South Dakota would apply the rule of *Comunale*[1] which it is claimed holds that an insurer who denies coverage does so at its own risk, and, that a good-faith-but-mistaken declination of coverage followed by a refusal to consider a settlement offer within the policy limits makes the insurer strictly liable for the amount of any judgment rendered against the insured including the excess over the policy limits.

It is our view that the ultimate test to be applied under South Dakota law in determining whether an insurer is liable for damages in excess of the policy limits

---

1. *Comunale* v. *Traders & General Ins. Co.*, 328 P.2d 198, 68 A.L.R.2d 883 (Cal. 1958).

is, "was the insurer guilty of bad faith in refusing to settle within the policy limits?" *Kunkel* v. *United Security Ins. Co. of New Jersey,* 168 N.W.2d 723 (S.D. 1969). This is a fact question to be determined from all the circumstances and elements involved in a particular case. *Kunkel, supra,* at p. 726, 730; *see also, Dairyland Insurance Company* v. *Hawkins,* 292 F. Supp. 947 (S.D. Iowa 1968); *Landie* v. *Century Indemnity Company,* 390 S.W.2d 558 (Mo. App. 1965). In determining the issue of bad faith in refusing to settle within the policy limits the trier of fact is entitled to consider, among other factors, the good faith of the insurer in refusing to defend because of the circumstances indicating lack of coverage. "Obviously, in considering its own interest the insurer may, in good faith, determine whether, under the circumstances, it would be held liable at all, i.e., whether there is coverage." *Beck* v. *Pennsylvania National Mutual Cas. Ins. Co.,* 429 F.2d 813, 819 (CA5 1970). The refusal to defend and refusal to settle within the policy limits are often interrelated. *See, Gordon* v. *Nationwide Mutual Ins. Co.,* 30 N.Y.2d 427, 334 N.Y.S.2d 601 (1972); *National Service Fire Ins. Co.* v. *Williams,* 454 S.W.2d 362 (Tenn. App. 1970). In the latter case the Tennessee Court of Appeals in reversing the trial court held that the insurer did not act in bad faith in refusing to defend and settle within the policy limits where the insured named in the policy unequivocally stated that the defendant driver did not have permission to drive the insured's automobile at the time of the accident. The trial court found from other evidence that the driver in question did have permission to drive and that the insurance company acted in bad faith in refusing to defend and in refusing to consider or make settlement. In reversing the appeals court observed:

> "We think an insurer, under circumstances such as depicted in this case, is justified in accepting as true the information given it by its named insured which has a bearing on the liability of the insurer under its policy, and that the insurer can act reasonably on the basis of the information without being guilty of bad faith."

The above case demonstrates the fundamental unfairness of a "refusal to defend at your own risk" doctrine.

In the matter at hand the trial court held as a matter of law that the defendant was not guilty of bad faith in its denial of coverage and refusal to defend, and therefore, denied the claim for damages in excess of the policy limits. 325 F. Supp. at 1334. It is our view that the controlling issue is whether the insurer's refusal to settle was in bad faith and that the good faith refusal to defend must be considered along with all other circumstances in making a finding with respect thereto. We would remand for a determination of that issue by the trier of fact.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

APPENDIX E

IN THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 71-1348

LARRY LUKE, Individually; LARRY LUKE, as Special Administrator of the Estate of LISA LUKE, Deceased; and KATHLEEN LUKE, *Appellants,*

vs.

AMERICAN FAMILY MUTUAL INSURANCE COMPANY, *Appellee.*

No. 71-1374

AMERICAN FAMILY MUTUAL INSURANCE COMPANY, *Appellant,*

vs.

LARRY LUKE, Individually; LARRY LUKE, as Special Administrator of the Estate of LISA LUKE, Deceased; and KATHLEEN LUKE, *Appellees.*

Appeal from the United States District Court for the District of South Dakota, Southern Division
Hon. Fred J. Nichol, Judge

SECOND PETITION FOR REHEARING

American Family Mutual Insurance Company, Appellee in Case No. 71-1348, and Appellant in Case No. 71-1374, hereinafter referred to as petitioner, respectfully petitions the Court to grant a rehearing by the Court en banc

with respect to the decision and opinions by the Court filed April 16, 1973, on the first motion for rehearing, which affirmed the effect of this Court's original opinion in this matter filed November 2, 1972, affirming in part and reversing in part the decision of the District Court reported in 325 F.Supp. 1130 (D.S.D. 1971).

Although the rules of procedure for this Court do not provide specifically for a second petition for rehearing, this Court in a similar situation previously allowed the filing of such a motion so that it might be considered by the Court and, the petitioner would have its record complete in the event the petitioner wished to apply for a writ of certiorari. *Frieze, et al.* v. *West American Insurance Company,* 190 F.2d 381 (8th Cir. 1951). For a similar ruling in another circuit, see *Sun Oil Company* v. *Burford, et al.,* 130 F.2d 10 (5th Cir. 1942).

POINTS RELIED UPON

This petition is based upon the following points:

1. The three opinions filed by this Court on rehearing on April 16, 1973, leaves in doubt the principle to be applied in determining the liability of an insurer to pay in excess of policy limits when a refusal to settle also involves a refusal to defend because while the majority opinion left the original opinion of this Court in effect, only three judges adopted the original opinion; three of the concurring judges refused to adopt the original opinion and three of the judges dissented.

2. This Court's original opinion, as affirmed by the majority opinion on rehearing, is in conflict with the previous opinions of the 5th Circuit Court of Appeals in *Beck* v. *Pennsylvania National Mutual Casualty Ins. Co.,* 429

F.2d 813 (5th Cir. 1970), and the 10th Circuit Court of Appeals in *State Farm Mutual Automobile Ins. Co.* v. *Skaggs*, 251 F.2d 356 (10th Cir. 1957).

3. The Court has decided the question of the effect of an insurer's declination of coverage upon its liability for excess over the policy limits in a way not in accord with the applicable decisions of the Supreme Court of South Dakota.

4. This Court, in its original opinion and again on rehearing, has decided the question of the effect of the statute of South Dakota (S.D.C.L. 21-2-1) limiting the recovery for breach of contract in a way not in accord with the applicable decision of the Supreme Court of South Dakota interpreting that statute.

ARGUMENT

1. The Three Opinions Filed by This Court on Rehearing on April 16, 1973, Leaves in Doubt the Principle to Be Applied in Determining the Liability of an Insurer to Pay in Excess of Policy Limits When a Refusal to Settle Also Involves a Refusal to Defend Because While the Majority Opinion Left the Original Opinion of This Court in Effect, Only Three Judges Adopted the Original Opinion: Three of the Concurring Judges Refused to Adopt the Original Opinion and Three of the Judges Dissented.

The first opinion of this Court filed November 2, 1972, applied the per se liability rule expressed in *Communale* v. *Traders and General Ins. Co.*, 328 P.2d 198 (S.Ct. Cal. 1958). The rule is that an insurer declines coverage at its own risk regardless of the grounds for denial so that if in the final result the insured is held liable for excess over

the policy limits, then the insurance carrier is liable to that extent. A rehearing before this Court en banc was granted. On April 16, 1973, three opinions of this Court were filed. Three of the six judges concurring in the majority opinion reaffirmed the original opinion and three of the judges concurred on the basis of the opinion on rehearing only and on a different basis than that expressed in the original opinion. Judge Bright filed a separate dissenting opinion. Judge Stephenson, with Judge Gibson concurring, filed a separate dissenting opinion.

Judge Bright, in his dissenting opinion, describes the situation as follows, Rehearing Op. 6:

> "Courts seem to have applied three different rules in circumstances analogous to those in the instant case, as follows:
>
> "1) A rule that a good faith but mistaken declination of coverage insulates the insurance carrier from an excess judgment for refusal to accept an offer of settlement within the policy coverage. This is the rule which Judge Nichol applied in the trial of this case and which was also applied by the Fifth Circuit in *Beck* v. *Pennsylvania National Mutual Cas. Ins. Co.*, 429 F.2d 813 (1970) (Pennsylvania law), the Tenth Circuit in *State Farm Mutual Ins. Co.* v. *Skaggs*, 251 F.2d 352 (1957) (Oklahoma law), and *National Service Fire Ins. Co.* v. *Williams*, 454 S.W.2d 362 (Tenn. App. 1969).
>
> "2) The *Communale* rule, *Communale, supra*, 328 P.2d 198, of per se liability based on the California statutory law, which rule is not applied in this case by a majority of the Court.
>
> "3) A middle view which holds an insurer liable for more than the policy limits when the insurer, after

declining coverage in good faith, is shown to have failed to exercise good faith in refusing to settle or consider settlement of the claim within the limits of the policy. I construe the following cases to reflect this view: *Western Casualty & Surety Co.* v. *Herman,* 405 F.2d 121 (8th Cir. 1968); *Foundation Reserve Ins. Co.* v. *Kelley,* 388 F.2d 528 (10th Cir. 1968) (undisputed facts demonstrate bad faith refusal to settle as a matter of law); *Gordon* v. *Nationwide Mutual Ins. Co.,* 30 N.Y.2d 427, 334 N.Y.S.2d 601 (1972); *Landie* v. *Century Indemnity Co.,* 390 S.W.2d 558 (Mo. App. 1965).

"The initial panel opinion adopted the second rule. Although the majority of judges sitting *en banc* adopt the third rule, three judges of this *en banc* court join in the reversal of the district court for an alternate reason. These judges hold that, in considering whether a refusal to settle is in good or bad faith, the trier of fact should not give weight to a policy defense held in good faith by the insurer. I believe this view to be erroneous."

The panel hearing the appeal initially ruled that the insurer's good faith in denying coverage would not be considered on the basis of the rule expressed in the *Communale* decision, *supra.* In the majority opinion on rehearing, three concurring judges refused to follow the original opinion, basing their concurrence upon an application of the rule of bad faith expressed in the latest decision by the Supreme Court of South Dakota, *Kunkel* v. *United Security Insurance Co. of New Jersey,* 168 N.W.2d 723 (S.Ct. S.D. 1969). Rehearing Op. 2.

The rule expressed in *Communale, supra,* was not adopted by three of the concurring judges who disagreed with the original opinion. However, the effect of the ma-

jority opinion is to adopt the rule of per se liability expressed in the *Communale* case, *supra*. The Court's action on rehearing considered with the original opinion has left this issue in doubt. This is a question which, as Judge Bright noted, is important, Rehearing Op. 3, and should be resolved.

2. This Court's Original Opinion, As Affirmed by the Majority Opinion on Rehearing, Is in Conflict with the Previous Opinions of the 5th Circuit Court of Appeals in Beck v. Pennsylvania National Mutual Casualty Ins. Co., Supra and the 10th Circuit Court of Appeals in State Farm Mutual Automobile Ins. Co. v. Skaggs, Supra.

This petition should be granted on the separate ground that the original opinion and the effect of the majority opinion on rehearing conflict directly with the opinion of the Fifth Circuit Court of Appeals in *Beck* v. *Pennsylvania National Mutual Cas. Ins. Co.*, 429 F. 2d 813 (5th Cir. 1970) and the decision of the Tenth Circuit Court of Appeals in *State Farm Mutual Automobile Ins. Co.* v. *Skaggs*, 251 F. 2d 356 (10th Cir. 1957). In both of those cases there were parallel facts including a declination of coverage. The same issues were presented. The Fifth and Tenth Circuits adopted in those cases what Judge Bright denominated the first rule. Rehearing Op. 6.

These opinions are in conflict with the apparent effect of the opinions of this Court in the instant case because they express and follow principles to be applied in determining the liability of an insurance carrier for excess over the policy limits directly contrary to the principles apparently followed by the Court in the instant case.

The Supreme Court of South Dakota has not decided a case involving the effect of a declination of coverage and

refusal to defend. The Supreme Court of South Dakota did decide in *Kunkel, supra,* that an insurance carrier is not liable for excess amounts over the policy limits unless it refused to settle in bad faith considering *all of the circumstances at the time of the refusal to settle.* It did refuse to apply the hindsight test in determining the good faith of a refusal to settle and rejected the rule expressed in *Communale, supra.* Rehearing Op. 10.

The effect of the majority opinion on rehearing in the instant case gives the appearance that this Court has adopted the Communale rule that an insurer, regardless of justification, declines coverage at its own risk; that an insurer cannot consider its own interests equally with that of the insured; that if an insurer denies coverage, then by hindsight, depending upon the ultimate outcome, it is liable for any amount recovered against the policyholder even though that amount may be in excess of the policy limits; and that the circumstances involved in the denial of coverage shall be ignored if there was a refusal to settle, no matter how justifiable the declination of coverage was.

In the Communale rule, the reasons for the declination of coverage are not among factors considered in determining the good faith of the insurance carrier in refusing to settle and the insurance carrier is held liable for excess over the coverage limits. This is true even though the insured deliberately misstates the facts of the accident which leads to the declination of coverage. This was noted in *National Service Fire Ins. Co.* v. *Williams,* 454 S.W.2d 362 (Tenn. App. 1970). As Judge Stephenson remarked in his dissenting opinion on rehearing in the instant case, Rehearing Op. 11:

> "The above case demonstrates the fundamental unfairness of a 'refusal to defend at your own risk' doctrine."

The apparent effect of the opinions by this Court is to adopt this inherently unfair rule directly in conflict with the decisions of the 5th and 10th Circuits. This conflict should be resolved.

3. The Court Has Decided the Question of the Effect of an Insurer's Declination of Coverage upon Its Liability for Excess Over the Policy Limits in a Way Not in Accord with the Applicable Decisions of the Supreme Court of South Dakota.

The result of the majority opinion on rehearing is to apply the hindsight result test in determining good faith of an insurer in refusing to settle. This was done in spite of the rejection twice of the same test by the Supreme Court of South Dakota. *Kunkel* v. *United Security Ins. Co. of New Jersey,* 168 N.W.2d 723, 727; and *Crabb* v. *National Indemnity Co.,* (S.Ct. S.D. 1973) 205 N.W.2d 633. Further, *Kunkel, supra,* held that all of the circumstances existing at the time the settlement offer was made should be considered. The effect of the majority opinion coupled with the original opinion of this Court in the instant case is to eliminate a consideration of the reasons for declining coverage in determining whether the insurance carrier refused the settlement in good faith. In the present case, the events available for consideration by the insurer at the time of the refusal to settle certainly included the reasons for the refusal of coverage. This included a serious policy interpretation question which had not previously been interpreted by the Supreme Court of South Dakota. The refusal to defend and the refusal to settle within the policy limits are interrelated.

This Court's opinion in the instant case fails to follow the state law by adopting the hindsight test and refusing to allow the insurer to consider all of the elements

and circumstances existing at the time the offer of settlement was made in contravention of *Erie Railroad Co.* v. *Tompkins*, 304 U.S. 64, 82 L.Ed. 1188 (1937).

4. This Court, in Its Original Opinion and Again on Rehearing, Has Decided the Question of the Effect of the Statute of South Dakota (S.D.C.L. 21-2-1) Limiting the Recovery for Breach of Contract in a Way Not in Accord with the Applicable Decision of the Supreme Court of South Dakota Interpreting That Statute.

In the case of *Big Band, Inc.* v. *Williams*, 202 N.W.2d 121 (S.Ct. S.D. 1972), the Supreme Court of South Dakota interpreted (S.D.C.L. 21-2-1) as follows, l.c. 123:

> "When the action is for breach of contract, plaintiff is entitled to recover all his detriment proximately caused by the breach, not exceeding the amount he would have gained by full performance." (Emphasis supplied)

If the insurance carrier had given full performance to the contract and paid the entire amount of the policy coverage, the Lukes as claimants could not possibly have gained more than the policy coverage. This would not entitle them to excess over the coverage limits.

Justice Bright notes in his dissenting opinion that this statute in South Dakota and its interpretation by the highest court of that State casts grave doubt on the applicability in South Dakota of the sweeping pronouncement of *Communale, supra*. Rehearing Op. 6.

In this independent respect, the effect of the present opinions of this Court are in conflict with S.D.C.L. 21-2-1 and the latest opinion of the Supreme Court of South Dakota interpreting that statute.

CONCLUSION

For all of the reasons stated above, this second petition for rehearing should be granted and considered by the Court en banc.

Harry P. Thomson, Jr.
Jack L. Campbell
914 Commerce Bank Building
P. O. Box 13007
Kansas City, Missouri 64199
and
J. B. Shultz
310 South First Avenue
Sioux Falls, South Dakota 57102
Attorneys for Appellee and Appellant
As Petitioner for Rehearing

Shughart, Thomson & Kilroy
and
Woods, Fuller, Shultz & Smith
Of Counsel

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1972

No. 71-1348

Larry Luke, etc., et al,
Appellants,

vs.

American Family Mutual Insurance Company,
Appellee.

No. 71-1374

Larry Luke, etc., et al,
Appellees,

vs.

American Family Mutual Insurance Company,
Appellant.

Appeals from the United States District Court for the District of South Dakota.

Second petition for rehearing filed by counsel for American Family Mutual Insurance Company having been considered, it is now here ordered by this Court that the same be, and it is hereby, denied.

May 21, 1973

APPENDIX F

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1972

No. 71-1348

Larry Luke, individually; Larry Luke, as Special administrator of the Estate of Lisa Luke, and Kathleen Luke,
Appellants,

vs.

American Family Mutual Insurance Company,
Appellee.

No. 71-1374

Larry Luke, individually; Larry Luke, as Special administrator of the Estate of Lisa Luke; deceased; and Kathleen Luke,
Appellees,

vs.

American Family Mutual Insurance Company,
Appellant.

Appeals from the United States District Court for the District of South Dakota.

JUDGMENT

These causes came on to be heard on the record from the United States District Court for the District of South Dakota and were argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, in these causes, be, and the same is hereby affirmed in part and reversed in part.

And it is further ordered by this Court that the claim is remanded to the said District Court for entry of judgment in accordance with opinion of this Court filed this day herein.

Costs taxed in favor of Appellants, Luke, et al.: November 2, 1972

Clerk's Docketing Fee:	$ 25.00
Cost of printing 10 copies of Appendix:	$ 1039.25
Cost of printing 25 copies of Appellant's brief	$ 255.50
Cost of printing 25 copies of Appellant's reply brief:	$ 224.00
Total costs of Appellants for recovery from Appellee in the U. S. District Court.	$ 1543.75

A true copy.

Attest:

Clerk, U. S. Court of Appeals, 8th Circuit.

June 6, 1973

APPENDIX G

UNITED STATES DISTRICT COURT
DISTRICT OF SOUTH DAKOTA
SOUTHERN DIVISION

CIV 70-24S

LARRY LUKE, Individually; LARRY LUKE, as Special Administrator of the Estate of LISA LUKE, Deceased; and KATHLEEN LUKE,
Plaintiffs

vs.

AMERICAN FAMILY MUTUAL INSURANCE COMPANY,
Defendant

JUDGMENT ON MANDATE

Pursuant to the opinion and mandate of the United States Court of Appeals for the Eighth Circuit, heretofore filed in these proceedings, it is hereby

ORDERED, ADJUDGED AND DECREED that the original judgment dated the 3rd day of June, 1971, be modified and amended pursuant to the direction of the United States Court of Appeals. It is hereby

ORDERED, ADJUDGED AND DECREED that Plaintiffs' cross-motion for summary judgment is granted wherein Plaintiffs claim the right to recover from the Defendant their entire judgments entered in State Court plus interest thereon from the 28th day of January, 1970, until paid. It is hereby

ORDERED, ADJUDGED AND DECREED that Plaintiff, Larry Luke, recover of the Defendant, American Fam-

ily Insurance Company the sum of $35,962.47 which includes (1) his entire State Court judgment plus accrued interest, (2) costs taxed in this Court plus accrued interest and (3) costs taxed in the United States Court of Appeals for the Eighth Circuit plus accrued interest which total sum shall bear interest at the legal rate until paid. It is further

ORDERED, ADJUDGED AND DECREED that Plaintiff, Larry Luke, as Special Administrator of the Estate of Lisa Luke, Deceased, recover of the Defendant, American Family Mutual Insurance Company, the sum of $37,471.79 which includes (1) his entire State Court judgment plus accrued interest, (2) costs taxed in this Court plus accrued interest and (3) costs taxed in the United States Court of Appeals for the Eighth Circuit plus accrued interest which total sum shall bear interest at the legal rate until paid. It is further

ORDERED, ADJUDGED AND DECREED that Plaintiff, Kathleen Luke, recover of the Defendant, American Family Mutual Insurance Company, the sum of $98,799.65 which includes (1) her entire State Court judgment plus accrued interest, (2) costs taxed in this Court plus accrued interest and (3) costs taxed in the United States Court of Appeals for the Eighth Circuit plus accrued interest which total sum shall bear interest at the legal rate until paid.

Dated at Sioux Falls, South Dakota, this 12th day of June, 1973.

By the Court:

Fred J. Nichol
Chief Judge

Attest:
William J. Srstka
Clerk of Courts
(Seal)